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TechNotes # 9

SBIC TechNotes

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GUIDELINES FOR SBA APPROVAL OF REQUESTS FOR OVERLINE INVESTMENTS

Regulations which pertain to Overline investments are found at 13 CFR 107.740. The general rule at §107.740 (a) states in relevant part:

- (a) General Rule. This §107.740 applies if you have outstanding Leverage or intend to issue Leverage in the future. Without SBA's prior written approval, you may provide Financing or a Commitment to a Small Business only if the resulting amount of your aggregate outstanding Financings and Commitments to such Small Business and its Affiliates does not exceed:
- (1) For a Section 301 (c) Licensee, 20 percent of the sum of:
 - (i) Your Regulatory Capital as of the date of the Financing or Commitment; plus
 - (ii) Any Distribution(s) you made under §107.1570(b), during the five years preceding the date of the Financing or Commitment, which reduced your Regulatory Capital; plus
 - (iii) Any Distribution(s) you made under §107.585, during the five years preceding the date of the Financing or Commitment, which reduced your Regulatory Capital by no more than two percent or which SBA approves for inclusion in the sum determined in this paragraph (a)(1).
 - (2) For a Section 301 (d) Licensee, 30 percent of a sum determined in the manner set forth in paragraph (a) (1) (i) through (iii) of this section.

Although SBA believes that SBICs should make every effort to plan for follow-on investments within their overline limit at the time their initial investment is made, SBA recognizes that many SBICs are asked to fund amounts which place the investment in overline status. Often, these financings take the form of bridge loans to provide liquidity to the small concern until the next round of equity financing can be put in place. However, SBA is also seeing situations in which the SBIC's investment is not being made to "bridge" the small concern to the next identified round of financing or some identifiable liquidity event. Rather, they are being made for an indefinite period of time and without any identifiable means of exiting or reducing the overline investment position. Unfortunately, in many such cases, the SBIC is the only source of financing for the small concern, and in the absence of the requested financing, the small concern will go out of business and the SBIC will be forced to write off its investment.

SBA's overline regulation was liberalized in December 1999 to allow the Regulatory Capital for overline purposes to be increased by return of capital distributions (as permitted under §107.1570(b) or §107.585) made during the five years preceding the investment. Because of the higher overline limit resulting from the add-back of up to five years of return of capital distributions as well as concerns about current economic and market conditions, SBA undertook a review of its practices with respect to approval of overline requests and noted in particular

- The interpretation by many SBICs of SBA's Policy and Procedure Release (PPR) #2001 that SBA will automatically approve overline requests which do not exceed 30% of Regulatory Capital. It should be noted that PPR # 2001 was issued July 15, 1989 and did not contemplate the increase in overline limit resulting from the add back of Regulatory Capital as now allowed.
- The increase of overline requests from SBICs which are approaching maturation and de facto wind down of their operations.

As a result, SBA has determined that the following general guidelines will apply to overline investments:

1. As a general rule, overline requests should only be made in unusual circumstances.

2. There is no automatic or routine approval of any overline request, including overline requests up to 30% of Regulatory Capital. SBA will review all requests on their individual merits.

3. In reviewing overline requests, SBA will assess the financial condition of the SBIC and where it is in its investment process (is it making investments in new portfolio concerns, or making only follow-on investments). For those SBICs experiencing significant capital impairment or which are substantially invested, approval of such requests requires strong evidence that the provision of additional funding will significantly enhance the prospects for a successful exit from the investment. On a case-by-case basis, SBA may ask the SBIC's principals to share the risks of the increased portfolio concentration, e.g. by personally guaranteeing the SBIC's overline investment if the value of the portfolio company falls. Also, SBA is less likely to approve an overline request for a portfolio company which is experiencing serious or continuing financial difficulty than for a company which exhibits positive performance and is growing rapidly.

4. All overline requests must be accompanied by the following documents:

A. Financial Statements. Financial statements (pages 2 through 4) of SBA Form 468 as of a date not in excess of 60 days prior to the date of the request. A previously filed report meeting this requirement may be incorporated by reference.

B. Schedule of All Overlines. A schedule of all portfolio securities and assets acquired in liquidation that are overline must be submitted. The schedule should include the name of the small concern, the original principal amount of the investment, the amounts and dates of subsequent disbursements, and the amount outstanding at the date of the request for approval.

C. Affiliation with the Small Concern(s). A description of any direct or indirect affiliation between the SBIC and the small concern.

D. Financial Statements of the Small Concern. Fiscal year end financial statements and statements not more than sixty days old on the small concern must be submitted.

E. Description of the Investment. A complete description of all investments made by the SBIC in the small concern either current or proposed is to be furnished, including amounts and the major terms of the financing, in particular any conversion rights and any amortization requirements.

F. Other Participants in the Financing. The names of any other parties, SBICs or non-SBICs, which are participating in the financing, and the amount of the participation by each party.

G. Reasons for Overline Investment. The SBIC must provide a complete explanation of the need for the overline investment, including evidence of the requirements of the small concern for the funds and evidence that such funds are not available from other SBICs or other financing sources.

H. Anticipated Exit. A description of the anticipated exit from this investment (or the source of the reduction in the Overline position) including the approximate timing of the exit, identification of the parties (or types of parties) involved, and the amounts and timing of subsequent financing expected.

5. The amount of the capital distributions added back, compared to the then current Regulatory Capital will be a factor in the overline approval decision. For example, consider the case of an SBIC which currently has \$10 million of Regulatory Capital and which had made \$8 million of return of capital distributions to its private investors during the last 5 years. The SBIC requests an additional investment in a small concern which would bring its total, cumulative investment to \$4 million. After adding back the \$8 million, the investment would be 22.2 % of adjusted Regulatory Capital for overline purposes. However, it would represent 40% of the actual Regulatory Capital at the time the overline investment is made. Absent other mitigating factors, SBA would not be likely to approve this request. As a general statement, the greater the proportion of the distributed capital added back, the less likely SBA is to approve the requested overline investment. SBA will also consider the current stage of the fund (is the SBIC a recently started fund or is it a mature fund), the source of the previous return of capital distributions (were they the result of one large winner or several successful investments), the number of remaining small concerns in the portfolio, and the financial condition of the remaining portfolio.

Content comments or questions to: leonard.fagan@sba.gov

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